BELLSOUTH

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May 23, 2003

EX PARTE

Ms. Marlene H. Dortch
Secretary
Federal Communications Commission
The Portals
445 12th St. SW
Washington, D.C. 20554

Re: CC Docket 96-98

Dear Ms. Dortch:

On May 22, 2003, the following persons representing BellSouth met with Commission staff to discuss the Commission's rules for pricing unbundled network elements: Bob Blau, Pete Martin, Lisa Brooks and Glenn Reynolds. Representing the Commission at this meeting were Bill Maher, Jeff Carlisle, Rich Lerner, Josh Swift, Tamara Preiss, and Steve Morris. The attached documents were handed out and formed the basis for BellSouth's presentation.

Pursuant to Commission rules, please include this notice and attachments in the record of the proceeding identified above.

Sincerely,

Glenn Reynolds

cc: William Maher
Josh Swift
Tamara Preiss
Steve Morris
Jeff Carlisle
Rich Lerner

BELLSOUTH TELECOMMUNICATIONS, INC.

KEY ISSUES THE TELRIC NPRM MUST ADDRESS

- PRINCIPLES UNDERLYING TELRIC METHODOLOGY
  - TELRIC should reflect the costs that the ILECs will incur based on actual ILEC network topography and forward-looking technologies, *i.e.*, currently available technologies that may be introduced over time where economic justification exists to replace older technology
    - Current TELRIC methodology is based on a hypothetical most efficient carrier's use of the most efficient telecommunications technologies currently available and the lowest cost network configuration available
      - "Most efficient network" assumption under-compensates ILEC
      - Deters investment by competitive providers in alternative network facilities
        - Competitive providers can only profitably provide alternative facilities in niche markets where regulation provides sufficient price distortions for them to enter the market successfully
      - Fosters over reliance on under-priced UNEs
      - Creates disincentives for ILEC to make investment in its network because the UNE prices are insufficient to justify putting capital resources into the network when alternative uses of such capital provide a higher return on investment
      - The hypothetical construct of the most efficient firm is an economic death sentence for the ILEC because the construct is one that the ILEC cannot satisfy. It is impossible for the ILEC in reality to achieve the cost structure upon which the UNE price is established
    - A TELRIC methodology based on the ILEC's actual network topography and forward-looking technologies will be pro-competitive
      - It is a necessary prerequisite for pricing UNEs at a level that provides an ILEC with adequate compensation
      - It encourages efficient entry
        - Competitors will have incentives to invest in facilities where such investment will result in a lower cost network than that of the ILEC
        - Facility-based competitors are not disadvantaged by CLECs purchasing UNEs at prices that reflect realistic ILEC costs
        - The anti-competitive subsidy that competitors currently receive by purchasing UNEs at prices

based on hypothetical costs of the most efficient network is eliminated

- Costing methodology should be dynamic rather than static, reflecting the fact that an efficient firm's network is placed over time to serve growing demand with changing technologies
  - Current TELRIC methods assume a flash-cut construction of a network optimized to serve current demand.
  - In contrast, an efficient firm will size network facilities to minimize costs over time: switches will use a mix of original capacity and add-on capacity; a fraction of cable routes will contain multiple small cables rather than one large cable, etc.
  - A reasonable estimate of the equilibrium characteristics of a network that is dynamically efficient is given by the ILEC's current network topography.
- Costing methodology must be internally consistent, must be conducive to facilities investment, and must be predictable in application
  - Current TELRIC methodology suffers from internal inconsistencies
    - It is inconsistent to assume that the TELRIC methodology develops cost that replicate the costs that any efficient provider would incur in a competitive market, while also assuming the ILEC is a ubiquitous provider. In a competitive market, no one carrier will serve the entire customer base, so a cost study that assumes ubiquitous deployment and serving 100% of the available demand reflects economies of scale that are not achievable. Indeed, competitive carriers are already serving many low cost niche markets. Requiring an assumption of serving all customers results in UNE costs that are unrealistically low, and this results in competitors choosing to use the ILEC's UNEs rather than investing in their own facilities, because their costs to invest would always be higher than the ILEC's artificially low UNE costs.
  - Current TELRIC methodology is not conducive to facilities investment
    - It is inappropriate to assume that technological improvements instantaneously and ubiquitously drive down the cost of UNEs
    - ILECs are discouraged from new facility investments when faced with likelihood of under-recovery of costs via UNE rates
    - CLECs are discouraged from new facility investments when UNE prices are set artificially low such that it would be impossible for the CLEC to place facilities at a lower cost

- Current TELRIC methodology is inconsistent in application
  - State Commissions and legislatures have inconsistently applied the TELRIC principles, to the point where there is very little rhyme or reason to the development of UNE costs across the nation

- NETWORK DESIGN

  - In order to more accurately reflect the costs incurred by the ILEC, the appropriate network configuration must:
    - Assume existing wire centers and existing cable routes
      - If the existing cable routes are not assumed, the UNE cost is understated. The ILEC's actual cable routes were based on the availability of right-of-way and roads at the time the plant was placed. The assumption used in most "scorched node" cost models, which is based on "minimum spanning tree," tends to greatly understate actual cable route distances. Even BellSouth's "minimum spanning road tree" method, which calculates the minimum cable route distances assuming that the routes follow existing roads, understates the actual cable route distance. Indeed, if a CLEC were to place facilities, it would most likely follow the route of the ILEC's facilities, due to the existence of buildings, streets, rights-of-way, etc.
    - Assume that the ILEC's actual vendor mix is representative of the forward-looking technologies the ILEC will purchase during the study period
      - It is inappropriate to always assume the cheapest vendor and the cheapest type of equipment. There are valid reasons for sometimes choosing what appears to be, in a vacuum, a more expensive type of equipment. However, in the long run, that piece of equipment will be the most efficient for the situation in which it was used.
    - Assume that the ILEC's master contracts (which are competitively bid) are representative of the material and placement costs that will be incurred by the ILEC during the study period
      - As an example, if the master contract provides a cost per foot for burying cable, and that cost will be charged to BellSouth no matter what method is used to place the cable, it is inappropriate to assume, for example, that the contract cost should be used for trenching buried cable, but a cheaper cost that is unrelated to the contract should be used for plowing buried cable.
    - Assume a probability of structure sharing that represents what the ILEC can reasonably achieve over the study period

- BellSouth assumes a realistic probability that structure sharing will occur; however, it is inappropriate to assume that high percentages of structure sharing can be achieved by the ILEC or by any company choosing to place facilities. In a "green field" environment, there are often timing considerations that make structure sharing an unworkable or costly proposition. For example, power companies typically place facilities far in advance of occupancy, telephone companies typically place plant shortly before occupancy, and cable companies often wait until a sufficient number of homes are occupied before placing their plant. Thus, in the real world, structure sharing does not occur that often. Furthermore, in existing areas, the reality is that the "scorched" assumption the FCC requires for TELRIC methodology does not impact the power or cable companies – their facilities are already in place; therefore, BellSouth's being required to cost out the most efficient way to place new facilities should not require an unrealistic assumption that other utilities will be sharing structure costs with BellSouth.

- Assume that fill factors (utilization) will represent the ILEC's steady-state (utilization is lumpy, but over time, it is fairly constant)

- <u>OTHER ISSUES</u>

  - FCC should find that use of in-plant factors to estimate the cost of equipment installation is acceptable
  - Costs should reflect the risks and uncertainty inherent in a competitive environment
  - Reasonable profit – The Act says that ILECs are entitled to earn a reasonable profit in addition to their costs. A reasonable estimate of profit would be based on discount or hurdle rates used by companies in competitive markets

- <u>NONRECURRING COSTS</u>

  - There is a conflict between the modeling of forward-looking, most efficient technology for recurring costs versus the nonrecurring costs that an ILEC actually incurs
  - ILECs must be allowed to recover the actual one-time costs incurred to provision UNEs

TELRIC Pricing
NPRM

BellSouth Presentation
May 22, 2003

TELRIC PRICING

WHAT CONGRESS INTENDED:	***WHAT ACTUALLY OCCURRED:***
•Uniform, cost-based pricing principles	**•Inconsistent interpretation and application of TELRIC principles by state commissions**
•UNE rates that recover cost plus a reasonable profit	**•Bias toward understated costs; UNE rates that do not even recover cost, and certainly do not include a profit; ILECs subsidizing CLECs**
•UNE rates that support facilities-based competition	**•UNE rates so artificially low that few carriers are interested in true facilities-based competition**
•Remove implicit subsidies from retail rate structure	**•In the absence of retail rate rebalancing, geographic deaveraging of UNE rates simply created increased margins for CLECs in urban areas and a lack of competitive alternatives for customers in rural areas**

TELRIC PRICING

- Artificially low UNE rates result in CLECs being subsidized by ILECs
  - –ILECs incur all the risk, all the capital expenditures, and all the maintenance expenses
  - –ILECs retain carrier of last resort obligations while CLECs are free to "cherry-pick" their customers
- Calculating UNE costs in an unrealistic manner that results in costs that are artificially low ensures that there will NEVER be a carrier than can serve customers more "efficiently" than the ILEC
- The abundance of unused switches is proof that the UNE switching rates are artificially low

What Needs to be Done

- Assumptions must be consistent – i.e., if methodology assumes costs of an efficient provider operating in a competitive environment, cannot also assume lesser risks associated with a monopoly provider
  - UNE costs must realistically reflect costs that will be incurred by an efficient competitor
  - UNE Costs must reflect the risks and uncertainty inherent in a competitive environment

Key Issues

- Network Design – TELRIC Implications
  - Least cost, most efficient network configuration
    - Existing cable routes - ignored
    - Actual vendor mix - disregarded
    - Actual contracts – prices & conditions - disregarded
  - Forward-looking
    - Continually updated and re-evaluated
  - Modeling assumptions questioned
    - Structure Sharing
    - Fill Factors (Utilization)
    - In-plant versus bottoms-up

Key Issues

- Network Design – Realities
  - Flash-cut to forward-looking, least cost, most efficient network ignores the manner in which the network evolves
    - Cable sizes
    - Cable routes
    - Equipment
  - Costs are constantly re-evaluated --- lower costs anticipated by state commissions/CLECs --- ILECs never able to recover even the first artificially low rates before yet lower rates are set

Key Issues

- Nonrecurring
  - Conflict between modeling of forward-looking, most efficient technology and the costs BellSouth actually incurs to provision UNEs
  - Nonrecurring costs erroneously categorized as "embedded"
    - Unattainable provisioning processes envisioned by CLECs
  - Perceived "barrier-to-entry" – thus, substantial real costs are not recovered when nonrecurring rates are dramatically reduced to "promote competition"

NPRM Objectives

- Clarify costing and pricing rules
  - UNE rates must reflect realistic forward-looking costs
    - For example, recognize that ILECs acquire equipment and services in competitive markets; therefore, current contracts are best evidence of future costs
  - Require consistent assumptions concerning costs and risks inherent in a competitive environment
  - Nonrecurring costs should reflect costs that the ILEC will actually incur to provision UNEs
  - Statute requires recovery of cost plus reasonable profit
- Provide unambiguous direction to state commissions and set an aggressive timetable for states to implement revised costing and pricing rules

NPRM Specifics

- Network Design
  - Define what constitutes forward-looking
    - Emphasize that consideration of real-world constraints does not violate pricing rules
    - Recognize that current pricing rules do not allow ILECs to ever recover costs associated with capital expenditures
  - Specify that the use of actual data (e.g., for fill factors & structure sharing) does not violate TELRIC

NPRM Specifics

- Nonrecurring Charges
  - Specify that ILECs are entitled to recover the actual costs associated with provisioning UNEs
  - Specify that nonrecurring costs are to be recovered by nonrecurring charges